

# Executive Incentive Schemes in Initial Public Offerings: The Effects of Multiple-Agency Conflicts and Corporate Governance

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*Combining a behavioral agency perspective with research on multiple-agency conflicts, this article examines factors affecting the implementation of equity-based incentive schemes in initial public offerings (IPOs). With a unique sample of U.K. IPO companies between the years 1998 and 2002, it shows that conditional (performance-related) incentive schemes are negatively associated with share ownership and board power of the IPO's founding directors. However, the retained ownership of venture capital firms is positively associated with the probability of conditional incentive schemes. Board independence weakly effects on the toughness of executive compensation. The article's interesting findings suggest a number of avenues for a future analysis of the governance development process in threshold firms.*

**Keywords:** *IPO; governance; executive compensation; agency theory; founders*

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An increasing number of fast-growing firms face the decision to go public at different stages of their life cycle, and the process of initial public offering (IPO) has had increasing attention from academics (Jain & Kini, 1999; Ritter, 1987). Research on IPO companies has focused predominantly on areas such as issue performance (Brennan & Franks, 1997; Espenlaub & Tonks, 1998; Mikkelsen, Partch, & Shah, 1997; Pham, Kaley, & Steen, 2003)

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and its relationships with general corporate governance parameters such as board structure and characteristics (Beatty & Zajac, 1994; Certo, Covin, Daily, & Dalton, 2001; Filatotchev & Bishop, 2002). Within these diverse research streams, relatively little attention has been given to the role of executive compensation with regard to the IPO company. Although Beatty and Zajac (1994) argued the need for a more unified perspective on the control of executive compensation in the IPO company, there is little understanding among academics and practitioners of factors affecting the introduction of executive compensation schemes at the time of IPO and their structural characteristics, such as their relation to various performance targets established by the firm's board and shareholders.

Financial economists and organization theorists have developed a substantial body of literature on factors driving executive compensation and its organizational outcomes (see Conyon, Peck, Read, & Sadler, 2000, for an extensive literature review). Most of the executive compensation studies have been rooted in labor economics and agency theory and have focused predominantly on mature publicly listed companies. In recent years this research has provided fuel for commentators to criticize the remuneration received by top executive directors. Many U.S. studies have explored possible links between executive pay and the performance of the company, but these links have been found to be weak or nonexistent (Berkema, Geroski, & Schwalbach, 1997; Jensen & Murphy, 1990). Within the United Kingdom, these links also have not been strong (Conyon & Leech, 1994; Gregg, Machin, & Symanski, 1993; Main, Bruce, & Buck, 1996). Some researchers have argued that the incorporation of share-based incentive schemes can promote unethical reporting behavior by CEOs (Carson, 2003). This is particularly important as it is estimated that in the late 1990s, nearly 80% of the rise in CEO pay came from share options grants (Perel, 2003). More recently, research on compensation issues in the mature listed company has been widened to encompass areas such as compensation and option incentives (Conyon & Sadler, 2001), the structure of compensation contracts (Conyon et al., 2000), and governance issues such as board control and remuneration committees (Conyon & Peck, 1998). However, the structure and characteristics of executive share-based compensation in the IPO company still remains unexplored, even though IPOs represent a unique laboratory to study equity-based incentive pay schemes such as executive share options and long-term incentive plans at a crucial time in the firm's development, which is often referred to as a *strategic threshold* (Filatotchev, Toms, & Wright, 2006).

IPO context provides a number of opportunities for the development of more fine-grained analysis of various theoretical aspects associated with equity-based incentive schemes, such as *risk-incentive trade-off* (Prendergast, 2002) or *framing* of risk preferences within a behavioral agency framework (Wiseman & Gomez-Mejia, 1998). As Beatty and Zajac (1994, p. 315) have argued, studying newer firms that are considering a wider variety of internal governance mechanisms may provide a particularly clear test of the agency-based contingency perspectives. For example, the question of choice between conditional (*hard*) and unconditional (*soft*) share-option schemes ultimately concerns the effects of hard or soft targets on risk-taking behavior, but traditional agency-based corporate governance models are relatively silent on this issue (Wiseman & Gomez-Mejia, 1998, p. 142). Beatty and Zajac emphasized that because IPO firms may be particularly dependent on the existing top management team that usually includes the original founders, they may be more sensitive to managerial preferences for minimizing risk bearing than would larger firms.

Furthermore, unlike large mature firms with diffused external shareholders, IPO firms come to the stock market with more concentrated ownership patterns, with managers, founders, and early-stage investors, such as venture capitalists (VCs), still retaining substantial equity stakes after the flotation (Filatotchev, 2006). In a recent study, Arthurs, Hoskisson, Busenitz, and Johnson (2008) have argued that the IPO firms provide a multiple-agency setting associated with “conflicts of interest among more than one agent group” (p. 277). Such settings create a potential both for conflicting voices among various principal groups (Hoskisson, Hitt, Johnson, & Grossman, 2002) and for agents’ conflicting choices concerning which principals’ interests should have priority. For example, founders of the IPO firm, being large-block shareholders, may be considered as principals to nonfounding executive directors. At the same time, these founders may also retain executive positions, which turns them into agents of external shareholders, such as VCs. Likewise, VCs may be principals to the executive directors as well as agents to those who provide funds. However, multiple-agency research is silent with regard to how interests and risk preferences of multiple principals or agents in the IPO firm influence governance-related decisions such as the adoption of equity-based incentive schemes.

This article extends previous work in several ways. First, we make a contribution to corporate governance research by integrating multiple-agency and behavioral-agency theories and suggesting that combining them may help develop further agency-based models of executive risk-taking behavior and attitudes toward different types of equity-based incentives. Second, we develop further the multiple-agency framework by providing more fine-grained analysis of the governance roles of executive and nonexecutive founders, who very often are in charge of critical decision-making functions in entrepreneurial IPOs. The third contribution is that we show how different incentives and risk preferences of key shareholder constituencies in the IPO firm may affect the choice between soft and hard equity-based incentive schemes. Our last contribution is to the behavioral agency view of the board’s governance functions. By integrating behavior and multiple-agency perspectives, we argue that the specific board characteristics, such as board independence and founders’ control over the board, may determine the salience of multiple principals’ preferences, and therefore they should have a significant impact on the *toughness* of executive remuneration schemes.

## Conceptual Framework

Beatty and Zajac (1994, p. 315) argued that an IPO provides a unique opportunity to examine compensation arrangements and governance relationships that become formalized when an organization becomes an open corporation and its stock is openly traded for the first time. Although an IPO leads to a significant amount of capital raised with the issue of shares, it is often accompanied by the dilution of ownership from the existing shareholders to outside institutional and retail investors. Thus at the point of the IPO, founders and executives face both an exciting growth period and an uncertain time as they place shares beyond their control and into the open market. Agency theorists have argued that governance structures should be put in place to realign the interests of insiders and outside shareholders (Jensen & Meckling, 1976; Pagano, Panetta, & Zingales, 1998; Pagano & Röell, 1998), and linking executives’ remuneration to conditional share-option schemes is often considered a powerful

realignment mechanism. However, selecting equity-related incentive schemes may be problematic when there are different, perhaps conflicting voices in an IPO because of the multiple agent interests associated with different shareholder constituencies (Arthurs et al., 2008, p. 282). Therefore, the IPO firm's governance parameters may be an outcome of a complex pattern of principals' interests and agents' risk preferences associated with distribution of ownership and control within the newly listed firm (Filatotchev, 2006).

Building on the multiple-agency perspective of the IPO firm's governance aspects (e.g., Arthurs et al., 2008; Filatotchev et al., 2006) and behavioral agency research (e.g., Westphal & Zajac, 1995; Wiseman & Bromiley, 1996; Wiseman & Gomez-Mejia, 1998), this article argues that the IPO firm's decisions to implement equity-based incentive schemes and the extent of their toughness are not exogenous factors. Rather, they are linked to the distribution of retained ownership among multiple principals or agents, as well as their control over the IPO firm's board. We differentiate between the governance roles of four main groups of shareholders—nonfounding executive directors, executive founders, nonexecutive founders, and VCs—and consider their interests and risk preferences. Building on the behavioral agency research, we argue that founding and nonfounding executives should exhibit strong preferences for unconditional share-option schemes because their retained ownership leads to loss aversion (as opposed to risk aversion) within a gain-framed context (Tversky & Kahneman, 1986; Wiseman & Gomez-Mejia, 1998). However, the interests and risk preferences of nonexecutive founders and VCs underpin a strong principal perspective on executive remuneration, and building on *risk–incentive tradeoff* research (e.g., Prendergast, 2002), we argue that in the uncertain environment of an IPO, these two groups of investors may support the development of conditional, performance-related incentive schemes (Zahra & Pearce, 1989). Finally, we argue that the specific board characteristics, such as board independence and founders' control over the board, may determine the salience of multiple principals' preferences, and therefore these characteristics should have a significant impact on the toughness of executive remuneration schemes. The following sections develop these arguments further and suggest a number of testable hypotheses. We start our analysis with corporate governance aspects of share ownership of hired, nonfounding directors. Then we consider dual agency roles of executive and nonexecutive founders and early-stage investors. Our theoretical discussion concludes with analysis of the impact of board characteristics on the choice between conditional and unconditional share options in the IPO firm.

### **Multiple Agents, Ownership Structure, and Equity-Based Incentive Schemes**

In their seminal article on corporate governance, Jensen and Meckling (1976) indicated that the flotation of a company's shares on the public market leads to the *principal–agent concern*: how to reconcile the interests of incumbent managers and executive directors (as agents) with those of the company's ultimate owners—external shareholders (as principals). Corporate governance research suggests that appropriate mechanisms need to be put in place to motivate directors to align their own interests more closely with the shareholders', thus ensuring goal congruence. Incentive schemes for executive directors that are based on share

options have been discussed as the key way to help overcome agency problems (Beatty & Zajac, 1994; Fama, 1980; Fama & Jensen, 1983; Murphy, 1985), with greater amounts of the managers' compensation being tied directly to the performance of the company (Jensen & Murphy, 1990). At the point of the IPO, this issue becomes particularly relevant because a gradual process of *professionalization* of entrepreneurial ventures is usually accompanied by an increasing importance of hired, nonfounding executives (Daily & Dalton, 1992; Willard, Krueger, & Feeser, 1992). Indeed, some authors have argued that one of the reasons for a private company to go public is a possibility of introducing share-based incentive schemes for nonfounding key employees (Pagano & Röell, 1998).

Traditional agency arguments that the implementation and use of compensation schemes can potentially mitigate the misalignment of managerial incentives and associated agency problems have been challenged by studies of the incentive–risk trade-off (Beatty & Zajac, 1994; Holmstrom, 1979; Prendergast, 2002). This research has argued that linking a manager's remuneration too closely to firm performance could potentially lead to risk-avoiding behavior by the manager. While it can be argued that equity-based and performance-based compensation can have desirable motivational aspects, it may also cause the manager to have undesirable risk-bearing characteristics. Rappaport (1981, 1999) argued that managers, who act as the agents of the shareholders, are more risk averse than the owners of the company. Unlike owners of the company, who are able to diversify their ownership portfolio, managers have already invested their nondiversifiable human capital in the firm (Balkin & Gomez-Mejia, 1990; Gomez-Mejia & Balkin, 1992). As Scholes (1992) argued,

Managers are more likely to attach significantly more value to a given level of cash than to the same expected level in stock or options because they can use this cash to buy a diversified portfolio of common stock, bonds, or whatever. (p. 123)

In terms of compensation issues, the most significant part of risk bearing for executives is the acceptance of equity-based compensation within their compensation contract. Any form of equity-based pay will cause the executive to bear risk that could otherwise be more efficiently borne by the shareholders, who are able to diversify their investments. As a consequence of this, executives are more likely to have a preference for cash payment than for share options (Jensen & Murphy, 1990). This shift in managerial preferences may be particularly dramatic when incentive schemes are tied to tough measures linked to company performance, such as earnings per share, total shareholder return, and market share prices (Fama & Jensen, 1983). If company risk is high, then any proportion of remuneration that is equity based will be further loaded, not only with nondiversifiable risk, but also with company risk. As such, executives and shareholders will face very different levels of risk, and these risks can hinder the alignment of the two groups in the context of pay schemes that link pay to performance (Gray & Cannella, 1997; Wiseman & Gomez-Mejia, 1998).

Both agency arguments and the risk–incentive trade-off framework imply that risk preferences of managers may be contingent on the value of managers' equity holdings. From the traditional agency perspective, the higher the managers' equity position, the less severe the agency incentive problem, making it less likely that firms will need to use stock options in their compensation contracts. Similarly, the risk–incentives research argues that high equity

stakes in the firm mean that managers are relatively less diversified, and stock-based incentives would lead to their risk aversion. Both theories suggest that managerial ownership should be negatively related to the probability of hard performance contracts, *ceteris paribus* (Beatty & Zajac, 1994).

However, in the context of an IPO, this argument may be contested, considering the possible dilution of executive equity during the process of listing (Baker & Gompers, 2003; Certo, Daily, Cannella, & Dalton, 2003), especially if dilution occurs when the original shareholders partially exit by selling some of their equity in the IPO. Because dilution through the sale of existing shares may increase the extent of diversification of the executives, the multiple-agency framework (Arthurs et al., 2008) suggests that this increase in diversification, combined with their retained equity in the focal company, should bring nonfounding executives into closer alignment with other principals and change their risk preferences. As a result, executives may want to obtain some upside gains associated with conditional share options, and when controlled for share dilution, the effects of executive share ownership on conditional stock options should be neutral or positive.

More recent behavioral agency research (e.g., Wiseman & Bromiley, 1996; Wiseman & Gomez-Mejia, 1998) has helped untangle this complex web of incentive–risk problems associated with executive ownership and stock options. By combining agency arguments with *prospect theory* research (Kahneman & Tversky, 1979; Tversky & Kahneman, 1986), these authors have suggested that executives' risk preferences and decisions may be driven by *problem framing*, with their equity stakes being an important contingency affecting this framing. More specifically, an executive's current wealth may provide only a point of reference for assessing the prospects as opposed to directly influencing the preference for risk (Wiseman & Gomez-Mejia, 1998, p. 134). These arguments may have particular relevance in the context of IPO firms.

Even though there is a direct dilution of ownership at the time of the listing, founding and nonfounding executive directors usually retain a significant proportion of ownership at IPO (Filatotchev, 2006). The lock-up restrictions on equity trading after the IPO may create transaction costs that prevent executives from adjusting their equity holdings to an optimal level (Beatty & Zajac, 1994). Therefore, the magnitude of the retained equity positions after the IPO may influence executives' willingness to accept further risk bearing in their compensation contract. More specifically, using locked-up executive equity as a reference point for framing problems as gain or loss, behavioral models predict that executives should exhibit risk-averse preferences when considering the appropriateness of different types of incentive schemes within a gain context. It seems likely that members of an executive team see the IPO as a milestone of success and have high expectations for the future (Arthurs et al., 2008; Certo et al., 2001; Certo et al., 2003). Wiseman and Gomez-Mejia (1998) argued that this situation may shift executives' preferences from risk avoidance to loss avoidance and that executives may become more concerned with avoiding loss of perceived wealth than with attracting additional wealth. This results in more conservative risk-averse posture. These arguments imply that higher levels of retained executive equity after the IPO should influence the executives' risk preferences away from tough conditional share-option schemes and toward less-risky, unconditional schemes. Hence, we suggest



*Hypothesis 1:* The probability of conditional equity-based incentive schemes' being present in the remuneration contracts of executive directors in the IPO firm is negatively associated with the level of retained ownership by the nonfounding executive directors.

Previous studies of entrepreneurial IPOs have recognized the continuing, albeit diminishing, centrality of the founding team in the life of the threshold firm (Amit, Glosten, & Muller, 1990; Certo et al., 2001; Willard et al., 1992). Entrepreneurship research also indicates that the ability of the young firm's founders to formulate and implement strategic initiatives that capitalize on environmental opportunities is vital to organizational growth and survival (Finkle, 1998; Jayaraman, Khorana, & Nelling, 2000; Steier & Greenwood, 2000). Therefore, founder characteristics such as motivation and incentives have a direct impact on the firm's development and success in the long run (Daily & Dalton, 1997).

However, as mentioned above, the IPO process is accompanied by significant shifts in the distribution of ownership and control between founding and new shareholders that create misalignment of incentives and a related set of agency costs (Jensen & Meckling, 1976; Mello & Parsons, 1998). As Pagano and Röell (1998) have pointed out, "In this situation the main conflict of interest is that between the controlling shareholder and the minority shareholders, rather than between hired managers and the generality of shareholders" (p. 188). In addition, during the process of professionalization of the firm before it comes to an IPO, some founders may step down from executive positions and move to nonexecutive roles (Willard et al., 1992), and this change arguably aligns their interests with interests of external, minority shareholders.

Therefore, entrepreneurial IPO firms provide a setting in which multiple-agency problems are particularly salient (Arthurs et al., 2008). More specifically, the firm's founders are, as a rule, majority shareholders, and as principals they should monitor executive directors (Sapienza & Gupta, 1994; Schulze, Lubatkin, & Dino, 2003). At the same time, they continue to serve in top executive positions, including the CEO position. However, the process of professionalization makes the founder cohort less homogeneous because some founders may have moved to nonexecutive roles. Therefore, the multiple-agency perspective should be augmented by considering potential differences in governance roles of executive and nonexecutive founders, and this research represents one of the first steps in this direction.

Behavioral agency arguments outlined above suggest that the framing of executive attitudes toward conditional share-option schemes depends on the amount of executive wealth associated with the IPO firm. It is the amount of perceived risk borne by the agents that affects their willingness to accept hard conditions attached to incentives. Founding executives, in addition to their financial wealth, have a substantial amount of human capital invested in their firm. Moreover, their long tenure, from the firm's inception to its IPO, creates strong psychological attachment to the firm, so its success and survival become part of a founder's identity (Arthurs et al., 2008). Therefore, from the behavioral agency perspective, founders' human capital investment and long tenure should be additional framing factors that reinforce negative attitudes toward additional risk associated with conditional share options.

On the other hand, nonexecutive founders may see themselves more as principals than as agents, especially when they retain a substantial equity stake in the firm after stepping down from their executive roles. In a complex environment of IPO, although they still may

be able to monitor executives' inputs, it is likely for them to have less knowledge about what the executives should spend their time on (Prendergast, 2002). Because nonexecutive founders are likely to have withdrawn from the strategy-making process and other key executive decisions, they have a reduced ability, compared with executive founders, to understand and evaluate executive decisions. In this case, the framing of decisions of executive and nonexecutive founders should be different, and in the absence of an effective mechanism of monitoring and evaluating complex positions when the optimal action is hard to pinpoint, nonexecutive founders are more likely to respond by offering the executives a pay-for-performance contract (Prendergast, 2002). This incentive will be stronger, the greater the wealth of the nonexecutive founders that is at stake.

These arguments extend multiple-agency research by suggesting that executive and nonexecutive founders may have different risk attitudes and governance roles within the IPO firm, with executive founders aligning their preferences with other executives but nonexecutive founders moving closer to the principal end of the spectrum. Hence, we suggest two linked hypotheses:

*Hypothesis 2a:* The probability of conditional equity-based incentive schemes' being present in the remuneration contracts of executive directors in the IPO firm is negatively associated with the level of retained ownership by the executive founders.

*Hypothesis 2b:* The probability of conditional equity-based incentive schemes' being present in the remuneration contracts of executive directors in the IPO firm is positively associated with the level of retained ownership by the nonexecutive founders.

Apart from insiders, entrepreneurial IPOs very often have external block holders, such as VCs. These investors provide equity finance at early stages of the venture's life cycle. As a result of this long-term involvement with the venture, VCs have increased incentives to monitor both the decision plans and decision outcomes of managers (Brav & Gompers, 1997; Carpenter, Pollock, & Leary, 2003). In particular, VCs impose contractual restraints on managerial discretion, including the use of staged investment, an enforceable nexus of security covenants, and the option to replace the entrepreneur as manager unless key investment objectives are met (see Megginson & Weiss, 1991, for a discussion). Therefore, from the agency perspective, VCs are unique principals in the IPO firm with superior monitoring capacities that should compensate for a relatively weak incentive alignment associated with nonconditional executive share options.

However, the multiple-agency framework suggests a different picture of the governance roles of VCs. Although VCs are principals to a focal IPO firm, they are also agents to those who provide their investment funds (Arthurs et al., 2008). Despite the fact that VCs often use an IPO as an exit opportunity, a substantial part of their equity holding still remains with the IPO firm because of the lock-up arrangements, which may last for more than a year (Filatotchev, 2006). Therefore, the pressure to show returns from their investment may last long after the IPO date, and this situation puts a serious burden on the monitoring capacity of VCs (Arthurs et al., 2008). As a result, there may be a strong argument that VCs' retained ownership after an IPO may lead to an increase in the probability of adopting performance-related share options.

First, the management literature has recognized increasingly that IPO is an important strategic stage in the life cycle of entrepreneurial firms, often referred to as the rebirth or



restart of organizations (Finkle, 1998, p. 6). At this critical juncture, a firm has overcome the first challenges of its entrepreneurial phase and entered a growth stage. As Fama and French (2004) emphasized, an IPO “is the point of entry that gives firms expanded access to equity capital, allowing them to emerge and grow” (p. 229). Prendergast (2002) argued that in this complex strategic environment, it is difficult to write an input-based contract because there is no clear understanding of what the agent should be doing; to provide such an incentive would involve frequent and complex recontracting. She suggested that “the purpose of offering conditional pay schemes is not simply to induce effort, since an input-based contract could do this, but to induce executives to carry out the right kinds of efforts” (p. 1091). Second, because VCs’ special rights associated with a venture capital contract end at the time of an IPO, when the need for oversight is particularly great, VC investors may compensate for a relative loss of control by strengthening other governance mechanisms, such as by increasing incentive alignment through conditional share options (Black & Gilson, 1998). Finally, although behavioral agency theorists did not explicitly study behavior of VCs, their arguments, combined with the multiple-agency perspective on VCs, suggest that because of the finite time horizons associated with lock-up arrangements, VCs may shift their reference point toward encouraging executives’ risk exposure by introducing conditional share-option schemes. These arguments are consistent with empirical evidence related to more mature listed firms. For example, David, Kochhar, and Levitas (1998) found that the nature of ownership in U.S. firms was an important determinant of CEO compensation. In particular their research supported the case that institutional investors (with only an investment relationship) showed preferences toward lower overall levels of cash compensation with an increase in the proportion of compensation received from long-term incentives. Thus,

*Hypothesis 3:* The probability of conditional equity-based incentive schemes’ being present in the remuneration contracts of executive directors in the IPO firm is positively associated with presence of a retained ownership by VCs after the IPO.

## **Board Characteristics and Equity-Based Incentive Schemes**

In the previous section, we linked the type of executive share-option schemes to the patterns of ownership and control in the IPO firm. Using the multiple-agency framework, we argued that there may be tension between the governance roles of executive and nonexecutive founders, executive directors, and VCs in terms of defining toughness of executive incentive schemes. Here we extend these arguments further by suggesting that compensation design may also depend on board parameters of the IPO firm, because this decision is ultimately a prerogative of the board and its committees. Therefore, board characteristics should have a bearing on the risk–incentive trade-off associated with executive share options.

From the agency perspective, to change managerial risk orientation and align managers’ interests with the interests of principals, firms not only need to set up incentive systems but should also make sure that the board is actively involved in the critical functions of active monitoring and evaluation of decisions made by the CEO and other top management team

members (Fama & Jensen, 1983). The effectiveness of these monitoring and control functions has usually been related to the extent of board independence and has often been approximated by structural factors such as the proportion of outsiders on the board, CEO and chairperson roles held jointly or separately, and so forth (Daily & Dalton, 1997; Zahra & Pearce, 1989). Beatty and Zajac (1994, p. 317) suggested that a higher level of monitoring by boards would be required when executives resist accepting compensation risks tied to firm performance. They stressed that traditional agency studies have emphasized the primacy of incentive alignment in terms of dealing with agency problems, with monitoring being related to the magnitude of incentive gap. This line of argument suggests that monitoring should be a substitute for deficient managerial incentives.

This view has been challenged by research on corporate governance as a system of interdependent elements, which explores how governance practices interact and potentially complement each other as related bundles of practices (Aguilera, Filatotchev, Gospel, & Jackson, 2008; Rediker & Seth, 1995; Walsh & Steward, 1990). Governance practices here are not seen as being universally applicable. Rather than isolated best practices, corporate governance practices become effective only in particular combinations. Complementarities concern such interactions between practices and how these interdependencies align governance to potentially diverse organizational environments. Therefore, monitoring may be complementary to incentive systems associated with executive stock options.

These arguments may be particularly relevant within the multiple-agency context, in which principal-agent dualities lead to different risk-incentive trade-offs among shareholder constituencies of the IPO firm. Therefore, apart from controlling the executives' actions and evaluating their performance, monitoring in this context should also involve setting and communicating performance standards to the executives. Behavior agency theorists argue that these standards should be strongly related to the principals' preferences. As Wiseman and Gomez-Mejia (1998) suggested, "unambiguous communication of these standards results in clear performance targets for the executive, which . . . should influence an agent's aspirations or reference point for success" (p. 144). If boards are vigilant in their role of protecting interests of noninsider shareholders, then the standards they set should be higher than the standards set by the agent. When this logic is applied within the multiple-agency context, it becomes clear that the specific board characteristics, such as board independence and founders' control over the board, may determine the salience of principals' preferences, and therefore board characteristics should have a significant impact on the choice of incentive schemes.

In the context of IPOs, executive directors are very often the original founders of the IPO firm, and previous research has suggested that the founder status of the CEO or chairperson may be an important dimension of executive power within the organization that leads to an *executive capture* of the board (Daily & Dalton, 1992; Ensley, Pearson, & Amason, 2002). In previous sections we argued that decision framing and risk preferences of founding and nonfounding executives are geared toward risk reduction associated with soft performance targets. As a result, in the presence of founders' control over the board and executive capture, performance targets should be lower, reflecting the agents' desire to establish accessible goals that reduce employment risk and ensure contingent pay (Wiseman & Gomez-Mejia, 1998). Hence,

*Hypothesis 4:* The probability of conditional equity-based incentive schemes' being present in the remuneration contracts of executive directors in the IPO firm is negatively associated with the presence of founders who are the CEO or chairperson.

On the contrary, board independence may tip the balance away from the interest of insiders toward protecting preferences of external shareholders and nonexecutive founders. Board independence enhances the vigilance of monitoring (Daily, Johnson, & Dalton, 1999; Golden & Zajac, 2001; Gulati & Westphal, 1999; Pfeffer, 1972; Shivdasani & Yermack, 1999; Westphal, 1999), especially at those points in the life cycle of the firm that involve strategic transition (McNulty & Pettigrew, 1999). Sociocognitive studies of corporate boards have extended agency research by suggesting that proactive behavior by independent directors may also be driven by the strategic perspective and base of experience provided by their appointments to other organizations (Carpenter, 2002; Carpenter & Westphal 2001; Westphal, 1999; Westphal & Zajac, 1995). Therefore, we may expect that independent directors will appreciate the importance of conditional equity-based compensation schemes as they gradually become a good governance standard in more mature listed firms. Board independence, therefore, should relate to the difficulty of performance targets and, thus, to the executives' reference point of success (Wiseman & Gomez-Mejia, 1998). Hence,

*Hypothesis 5:* The probability of conditional equity-based incentive schemes' being present in the remuneration contracts of executive directors in the IPO firm is positively associated with the level of board independence.

## **Data and Method**

### *The Sample*

The data sample used in this analysis comprises a unique data set of founder-led IPO companies in the United Kingdom. The data have been sourced both from the London Stock Exchange New Issues Listing and from the Market Information and Analysis section, which hold historical fact sheets for all issues since 1998 (including companies issuing additional shares, readmissions, and transfers between markets). The data sample has been collected from those companies floated on the London Stock Exchange (Main Market and the Alternative Investment Market) over a 5-year period from January 1, 1998, to December 31, 2002.

For the given period, the London Stock Exchange lists show us that 872 companies were floated as IPOs. Any company with non-U.K. incorporation was excluded as retaining it might lead to inclusion of different governance structures. The IPO prospectuses for all remaining 766 U.K. companies were obtained from Thomson Research, which provides comprehensive coverage of company filings for publicly quoted U.K. companies. Missing prospectuses were obtained either via company Web sites, or by telephone or written request to the companies or their advisors, whichever was deemed more appropriate. Any company deciding on U.K. flotation must produce a prospectus and file it with the Stock Exchange. Each prospectus was examined, and particular emphasis was given to the section detailing the history and founders of the company. Any companies that were unit or investment trust

were excluded from the sample first (because they have particular governance characteristics); then those deemed to involve a demerger, merger or acquisition, corporate spin-off, equity carve-out, or reorganization or that could be considered as solely acquisition vehicles were excluded (Filatotchev & Bishop, 2002). This resulted in 311 companies that clearly demonstrated that they had been developed via the entrepreneurial process with entrepreneurial founders and whose founders were serving as directors at the time of the company's flotation. Because our focus is on the decision to adopt conditional versus nonconditional share-option schemes, we excluded an additional 16 companies that did not have an executive share-option scheme at the time of IPO. Our final sample included 295 companies. Their listing prospectuses provide a wealth of information, including details of the company's financial history, background details about the board of directors and the directors' compensation contract, share ownership, and details of any equity-based incentive schemes, thus enabling the data variables to be collected from each company's document.

## Measures

*Dependent variable.* The dependent variable in this study is dichotomous and is measured as the presence of any conditional equity-based remuneration scheme (i.e., with specific performance criteria to be achieved in order for grants to vest) at the point of IPO. This information was taken primarily from the IPO prospectus, which gives details of such schemes to future investors. To ensure accuracy, where details in the prospectus were vague, and to prevent the possibility of missing data or a wrong assumption, annual reports and accounts after the IPO were checked with reference to the scheme date in the IPO prospectus.

*Independent variables.* Ownership of the company is stated in the prospectus in the section detailing "Directors' and Others' Interests" within the "Additional Information" in the prospectus. As a rule, the ownership in this section is broken down into the number of shares held by each director on the board and the percentage of the total equity held by each individual member. Details both prior to and at the time of the IPO are given together in this one section. Additional information about voting rights and whether the shares are beneficial or nonbeneficial is also stipulated, providing sufficient information for exact ownership details to be calculated. For this research, ownership details were carefully collated for each individual director, and the position on the board (CEO, chair, executive director, or nonexecutive director) was noted. Also, a dichotomous variable was created to indicate whether a board member was a founder of the company. By combining this information, the retained ownership variables were created for executive and nonexecutive founder-directors and other, nonfounder executives.

Later on in the same section of the prospectus, block holders (having greater than 3% share ownership) are also cited, thus enabling the identification of VC involvement. Attention was given to the section detailing any block investors in order to create a dummy variable indicating whether the company had retained ownership by VCs after the IPO.<sup>1</sup> Names of the block holders were identified and checked against the British Venture Capital Association list of membership (British Venture Capital Association, 2003).

The extent of founders' control over the board was operationalized by collating information relating to the position of the founders on the board of directors. Founders were often in key roles, such as the CEO or chair, and on occasion these roles were held dually. To measure this, a dummy variable, "CEO/Chair–Founder duality," was created. This variable was assigned a value of 1 if the roles of the CEO and chair were combined and held by a founder of the firm, and 0 otherwise. On the basis of previous research, a continuous variable measuring the ratio of independent (nonexecutive in the United Kingdom) directors to the total number of board members was used to operationalize the extent of board structural independence (see Filatotchev, 2006, for an extensive discussion).

*Control variables.* Several control variables were used. The sample of entrepreneurial IPO companies bridges a 5-year period that covers a bullish peak in the market midway and then a slower bear market. As a result of this market fluctuation, a dummy variable was created to indicate flotation before the peak (April 2000).

To moderate for the method of issue and the market floated, an additional dummy variable was created for those companies that floated via the placing method. With a placing, shares are sold directly to selected institutional investors. While this method gives the company more discretion to choose its investors, it results in a narrower shareholder base, which may have an effect on involvement of block holders (Pike & Neale, 2003). Similarly, companies floating on the Alternative Investment Market were identified by a coded dummy variable.

Because the *ex ante* IPO's risk is an unobservable and multidimensional factor, we used a number of proxies to operationalize it. In line with previous research on IPO companies, the first measurement for risk was taken from the risk factors discussed in the prospectus. These were simply counted to provide a continuous measure of the risk of the firm, and a number of studies consider this measurement to be an adequate proxy for the risks surrounding a firm (Beatty & Zajac, 1994; Certo et al., 2001; Cyr, Johnson, & Welbourne, 2000). A second measure for risk was created on the basis of the strength of the present executive team, with particular reference to the founder executives. A dichotomous variable was created to indicate whether the loss of founder or key personnel within the executive team was mentioned within the risk factors (1 = *yes*, 0 = *no*). If such a loss had occurred, it would be a particular risk to the further performance and direction of the company.

The third proxy measure for risk was derived from the profitability (or unprofitability) of the firm as disclosed to future investors in the IPO prospectus. Unfortunately, because of the age of many of the firms, a trend variable proved to be impractical. So in line with previous research, a dichotomous measure was created (1 = *profitable*, 0 = *unprofitable*; Beatty & Zajac, 1994). The fourth measure for risk also reflected the profitability or unprofitability of the firm. This was an expansion of the dichotomous measure above in that the variable was made ordinal over the 4-year period prior to the IPO. No trading or a loss disclosed in any single year prior to the IPO was given the value of 1. Summing the values for each year gave a rank of 0 to 4. Hence over the 4-year period, companies with 0 were considered to have very low risk, compared with companies with a 4, meaning 4 years of either no trading or losses, which were assessed as indicating very high risk.

Because these proxies are not without weaknesses, we introduced an *ex post* measurement of risk based on stock price volatility, measured by taking the standard deviation of the

first 30 days' trading prices for the shares. Finally, we used a sectoral measurement of risk by creating a high-tech-company dummy for firms from high-tech industries such as information technology, computers and software, and so forth.

The age of a firm was used to control for its sophistication because its organizational structure and the development of governance systems may be linked to a life cycle development effect. Previous research within mature companies has shown that size might also be seen as a determinant of the executive compensation contract (Conyon et al., 2000; Gregg et al., 1993). To control for the size of the IPO company, two variables were considered: the market capital value of the firm at the point of the IPO and turnover in the year prior to the IPO. Using market capital value at the time of the IPO to control for size has specific problems. The value placed on the share price might be influenced by the adoption of governance factors, including the provision of equity-based incentive schemes (Beatty & Zajac, 1994; Certo, 2003; Certo et al., 2003). Indeed, market capitalization may be undervalued as information asymmetries between the various teams involved in the IPO process can lead to *underpricing* (when the initial offer price is less than the 1st-day close-of-trade price; Certo et al., 2001; Filatotchev & Bishop, 2002; Michaely & Shaw, 1994). Alternatively, governance signals (including retained ownership levels) may have a positive effect on the value of the firm (McBain & Krause, 1989; Mikkelsen et al., 1997). With these factors in mind, the measure of market capitalization as a control for the size of the organization might have considerable endogenous and exogenous influences. For this reason, sales turnover was used to provide an adequate control for the size of the firm.

As indicated in the theory section, dilution of ownership can also influence adoption of performance-based incentives. To control for this, dilution of the founders and other non-founder executive directors was measured as the percentage difference between the shares owned prior to and at the point of the IPO.

### *Analytical Technique*

Ordinary least squares regression analysis makes the assumption that any linear model is continuous, homoskedastic, and normally distributed. Thus, with the dependent variable being the presence of conditional equity incentive schemes within the compensation contract of the executives, the use of ordinary least squares regression to model this data is inappropriate. When the dependent variable is of a dichotomous nature, a more appropriate tool is multiple discriminant analysis or a logistic regression model (Hair, Anderson, Tatham, & Black, 1998). In most applications of this nature, the logit and probit models are quite similar, with the main difference being that the logistic distribution has slightly flatter tails (Gujarati, 2003). For comparison, both logit and probit models have been run on the variables. The results for both models were similar, with only marginal differences in the levels of significances. With such similar results, only those of the logit model have been reported.

## **Empirical Results**

Tables 1 and 2 provide the descriptive statistics and correlation matrix and for all variables used in the study. Of the sample of 295 companies, 49.2% of the executive share-option



**Table 1**  
**Means, Median Values, and Standard Deviations**

Variables	<i>M</i>	Median or % <sup>a</sup>	<i>SD</i>
Dependent variable			
• At IPO presence of any conditional share-option scheme		49.21	
Independent variables			
• Nonfounder executives' ownership (%)	4.32	1.17	7.19
• Executive founders' ownership (%)	27.74	23.60	21.61
• Nonexecutive founders' ownership (%)	3.14	0.00	10.67
• Venture capitalist-backed company		27.00	
• CEO/chair founder		86.78	
• Board independence	41.93	40.00	14.04
Control variables			
• Annual turnover (£,000)	22,128	2,719	90,703
• Age of company (years)	6.48	5.00	6.44
• No risk factors	11.96	10.00	7.43
• Departure of key personnel		70.34	
• (Un)profitability risk		61.00	
• Previous trading/(un)profitability		2.59	
• Share price volatility	47.70	7.01	299.03
• Float date pre-dot-com bubble		30.51	
• Technology company		29.00	
• Founders' dilution (%)	13.12	10.41	14.57
• Executives' dilution (%)	2.40	0.36	6.53
• Placing method		84.00	
• Alternative Investment Market flotation		71.00	

a. Percentages are reported for the 0/1 variables.

schemes had some form of performance criteria attached in order for shares to vest to the executives if these conditions were met (or exceeded). The large number of companies operating schemes at the IPO shows the importance attached to these schemes, both internally and externally.

Table 1 also shows that founder directors were by far the predominant group of insider shareholders, retaining more than 30% of voting shares after the IPO on average. Founders in executive roles represented the largest block owners, holding on average 27.74% of total shares. Clearly, our data are consistent with the multiple-agency framework suggesting that founders could be considered as agents and principals, depending on the context. Other non-founder executives' ownership was relatively low, at 4.32%, and 27% of IPOs in our sample had VC backing at their IPO.

In terms of board structure, independent directors held 42% of board seats on average. However, the inclusion of nonexecutive founders who continued to have ownership (mean, 3%) might bring the levels of true independence into question. A founder was the firm's CEO or chair in more than 80% of cases, indicating that founders had retained strong leadership positions even at the IPO stage.

**Table 2**  
**Correlation Matrix for All Variables**

Variable	1	2	3	4	5	6	7	8	9	10
1 At IPO, presence of any conditional scheme	1									
2 Nonfounder executives' ownership (%)	.068	1								
3 Executive founders' ownership (%)	-.010	-.063	1							
4 Nonexecutive founders' ownership (%)	-.096	-.040	-.252**	1						
5 Venture capitalist-backed company	.089	-.173**	-.211**	-.002	1					
6 CEO or chair founder	-.072	-.057	.288**	-.007	-.050	1				
7 Board independence	-.003	-.241**	-.312**	.182**	.164**	-.091	1			
8 Annual turnover (£, 000)	.096	.085	-.043	.046	.079	.031	.002	1		
9 Age of company	.166**	.091	.065	-.035	.139*	-.020	-.005	.401**	1	
10 No risk factors	.039	-.150*	-.146*	.136*	.210**	-.063	.270**	.236**	.048	1
11 Departure of key personnel	-.147*	-.041	-.036	-.123*	-.003	-.084	.003	.020	-.116*	.175**
12 (Un)profitability risk	-.122*	-.062	-.182**	-.089	-.070	-.192**	.039	-.218**	-.441**	.073
13 Previous trading/ (un)profitability	-.165*	-.113*	-.269**	-.030	.014	-.163**	.064	-.209**	-.495**	.072
14 Share price volatility	-.031	-.001	-.042	-.018	-.047	-.137*	.049	-.007	-.048	.002
15 Float date pre-dot-com bubble	.117*	.123*	.087	.044	.015	-.039	-.050	-.002	.102	-.091
16 Technology company	.040	-.124*	.034	.012	.098	-.008	.049	-.037	.015	.101
17 Founders' dilution (%)	-.004	-.089	.094	.039	-.132*	.171**	-.029	-.048	-.058	-.129*
18 Executives' dilution (%)	.083	.411**	-.194**	-.032	-.116	-.017	-.136*	-.115	.043	-.067
19 Placing method	.027	.107	.013	-.038	-.044	.066	-.121*	-.205**	.014	-.383**
20 Alternative Investment Market flotation	-.198**	.074	.139*	-.088	-.304**	.057	-.215**	-.275**	-.270**	-.573**

(continued)

**Table 2 (continued)**

Variable	11	12	13	14	15	16	17	18	19	20
11 Departure of key personnel	1									
12 (Un)profitability risk	.181**	1								
13 Previous trading/(un)profitability	.226**	.779**	1							
14 Share price volatility	.074	.079	.081	1						
15 Float date pre-dot-com bubble	-.338**	-.181**	-.224**	.095	1					
16 Technology company	.086	.073	.065	.043	.015	1				
17 Founders' dilution (%)	-.081	-.091	-.068	-.057	.087	-.119	1			
18 Executives' dilution (%)	.028	-.086	-.040	-.012	.029	-.122*	.109	1		
19 Placing method	-.045	.002	-.056	-.010	.068	-.101	.016	.132*	1	
20 Alternative Investment Market flotation	.104	.219**	.207**	-.098	-.166**	-.234**	.103	.082	.226**	1

\* Correlation is significant at the 0.05 level (2-tailed).

\*\* Correlation is significant at the 0.01 level (2-tailed).

The results of the formal tests of our hypotheses are provided in Table 3. We introduced the main explanatory variables in a stepwise fashion, which helps verify whether the main regressors contributed to the explanatory power of the models used.

As the models show, the riskier firms are less likely to have conditional share-option schemes, in line with the risk–incentives trade-off framework. Large firms are more likely to introduce conditional schemes, which, again, may be a reflection of their relatively lower level of risk compared with smaller ventures.

As Model 1 shows, nonfounding executive share ownership does not have any significant effects on the probability of conditional schemes. Although the nonfounding executives do have ownership in the company, the level of this ownership (mean, 4.34%) may be not enough to provide a substitution effect with regard to incentive schemes. Thus our Hypothesis 1 is not supported.

The results in Model 2 provide a negative impact of the executive founders' ownership variable on the probability of conditional schemes, thus giving marginal support in line with Hypothesis 2a. However, contrary to Hypothesis 2b, the retained ownership of nonexecutive founders also has a significantly negative effect. When we introduced combined founders' ownership in Model 2, this variable had a strongly significant and negative effect. The level

**Table 3**  
**Logistic Regression Results**

Dependent Variable	Conditional Scheme Logit Model 1	Conditional Scheme Logit Model 2	Conditional Scheme Logit Model 3	Conditional Scheme Logit Model 4	Conditional Scheme Logit Model 5
Constant	-2.027	-1.506	-1.789	-0.973	-1.908
Nonfounder executives' ownership	.002	.001	.008	.003	.010
Executive founders' ownership		-.010†	-.007†	-.001†	-.003†
Nonexecutive founders' ownership		-.060*	-.063*	-.068*	-.070*
Venture capitalist backing			.650**	.670**	.689*
CEO/chair founder				-.995**	-.993**
Board independence					1.532†
Controls					
Log turnover year-1 (£, 000)	.456*	.513*	.504*	.571**	.594**
Age of company	.055†	.052†	.056†	.043	.041
Number of risk factors	-.024†	-.021†	-.020†	-.026†	-.030†
Departure of key personnel	-.216†	-.030†	-.085†	-.162†	-.183†
(Un)profitability	-.511	-.696	-.634	-.680	-.666
Previous trading/ (un)profitability	.427*	.422*	.407*	.398*	.422*
Share price volatility	.000	.000	.000	-.001	-.001
Float time dot.com bubble	.006	.065	.071	.059	.075
Technology company	.132	.055	.001	.028	.041
Founders' dilution	-.011	-.009	-.009	-.006	-.007
Executives' dilution	.044	.036	.037	.044	.049
Placing method	.112	.266	.340	.405	.355
Alternative Investment Market flotation	-.364	-.207	-.076	-.164	-.093
% correct predictions	63.9	64.5	64.9	67.3	67.9
Nagelkerke $R^2$	.130	.174	.193	.21.5	.22.4
Model $\chi^2$ value	17.28	23.63†	26.14†	29.40*	30.81*

† $p < .10$ \* $p < .05$ \*\* $p < .01$ \*\*\* $p < .001$ 

of retained ownership by the founders (mean ownership of 31%) shows that they still effectively control the firms, and their risk preferences are similar to nonfounding executives'. It seems that, regardless of their role in the firm, the retained ownership of the founders prevents introduction of conditional share-option schemes for executive directors, and we will return to this result in the discussion.

As Model 3 shows, VC-backed IPOs are more likely to have incentive pay schemes with specific performance targets attached. Therefore, Hypothesis 3 is supported. The presence of VCs positively enhances the governance of the firm, in line with our theoretical predictions.

The founders not only have considerable power within the organization via their levels of ownership; they also often retain powerful board positions. Model 4 shows support for our

Hypothesis 4, and the presence of conditional equity-based incentive schemes in the remuneration contracts of executive directors is negatively associated with founders' board power and position, even though after the IPO the ownership dynamics change. Finally, Model 5 shows there is a positive association between conditional incentive schemes and the levels of board independence. However, this is significant at the 10% level, thus providing marginal support for our Hypothesis 5. This result does, however, reinforce the multiple-agency effects and potential tension that can occur within the board of such companies at the time of their IPO.

## Discussion

The bringing together of behavioral agency theory and multiple-agency perspective has enabled a more fine-grained study of the impact that ownership structure and board characteristics can have on the governance of a company and, in particular, the use of equity-based incentive schemes to tie executives to performance and increasing shareholder return. Our analysis suggests that, in the context of IPO firms, the introduction of equity rewards tied directly to objective performance measures is an outcome of the complex pattern of risk preferences and monitoring capacities of different shareholder constituencies, including the original founders, hired executives, and early-stage investors. The balance between these "conflicting voices" (Hoskisson et al., 2002) in terms of the adoption of incentive schemes also depends on board configurations, with agent-centered boards leading to the introduction of soft share-option schemes. This finding extends the multiple-agency research (e.g., Arthurs et al., 2008) by suggesting that organizational outcomes of more than one agent group may also be linked to an agent's influence over the focal firm's board.

The findings suggest that the founders of newly listed firms, regardless of whether they are in executive or nonexecutive roles, are still very much in control and resist executive equity rewards' being tied directly to objective performance measures. More specifically, nonexecutive founders, despite being large-block shareholders, seem to collude with the executives when setting up incentive schemes. Although the multiple-agency perspective would suggest that nonexecutive founders' interests should be aligned with those of external shareholders, such as VCs, as we argued in a preface to Hypothesis 2b, our finding indicates that their governance role is different from that of external large-block holders. This finding is quite important because it suggests a promising avenue for future theory building within the context of agency research.

The multiple-agency framework developed by Arthurs et al. (2008) does not account for possible differences in monitoring abilities and risk preferences of principals in an IPO, although from a behavioral agency perspective, there may be compelling reasons to argue that founders' framing of risk-related decisions may differ from that of external shareholders. First, despite possible dilution of their ownership, nonexecutive founders still have their human and financial capital associated with the focal firm, and therefore they are not as risk neutral as diversified external shareholders are. From the behavioral agency theory point of view, this should frame their risk preferences away from extensive risk taking associated with business strategies driven by conditional executive share options. Second, nonexecutive founders may still be closely involved with the firm they set up in the past and helped to develop. As principals, they may have a good idea of what the executives should be doing

after flotation, so by observing efforts they can be sure that private and social benefits are aligned (Prendergast, 2002). Again, this finding diminishes the importance of output-based incentive contracts for the executives, bearing in mind their potential costs for the firm. Our empirical finding suggests that an integration of research on risk–incentive trade-offs and behavioral agency perspective with multiple-agency theory may enrich our understanding of complex governance issues in threshold IPO firms.

Our analysis also suggests that the founders are still able to exercise strong board leadership, including influence on incentive strategies. Tied with the power of the founder-CEO or -chair, firms are maintaining a *foundercentric* structure, and founders have sufficient power to negotiate governance arrangements that positively preserve their influence and reward their length of service rather than their performance by allowing incentive grants to be unconditional. However, we did not find evidence of the “good governance” roles of independent directors, although our results are only weakly significant. This brings into question the selection processes for these directors, as well as the extent of their independence from the founding directors in the context of IPOs.

However, it is not totally a founder self-governing picture that emerges from our analysis. Entrepreneurial firms that come to an IPO often have significant equity stakes held by early-stage investors, such as VCs. Previous studies of the governance roles of VCs are rather ambiguous in terms of their impact on incentive and monitoring systems during and after the IPO. Most researchers emphasize the exit-oriented nature of VC investment, which may undermine VCs’ willingness and ability to participate effectively in governance of new issues (Black & Gilson, 1998). Our findings clearly show that this may not be a universal case, especially when VCs continue to own shares after the IPO. Using behavioral and multiple-agency frameworks, we argued that VCs are a special case of block holders who appears to be actively involved in the governance development process. However, the emphasis of this involvement may shift from direct monitoring to more active use of performance-related incentives after the IPO. Within this context, it is no surprise to see a positive association between VC involvement after the IPO and the presence of conditional equity-based incentive schemes.

Previous research has recognized that governance mechanisms operate interdependently, with overall effectiveness depending on a simultaneous operation of several mechanisms in limiting managerial opportunism (Rediker & Seth, 1995; Walsh & Steward, 1990). Different governance mechanisms can complement each other (Aguilera, Filatotchev, Gospel, & Jackson, 2008; Dalton, Daily, Certo, & Roengpitya, 2003), and the cost–benefit trade-offs among a variety of governance mechanisms would determine their use (Rediker & Seth, 1995, p. 88). We extend this research further and make two contributions. First, we suggest that a substitution hypothesis associated with incentives and monitoring functions of corporate governance suggested by traditional agency perspective provides a simplified picture that does not take into account behavioral aspects of different constituencies within the multiple-agency framework. Our arguments and empirical findings are in line with a complementarity hypothesis (e.g., Dalton et al., 2003) that seems not only to have relevance within the context of mature firms with diffused share ownership but also to play a very important role in terms of mitigating conflicts between founders and shareholders in the IPO firm. Second, we analyze links between toughness of executive compensation and general governance factors in threshold firms, and this area has been largely overlooked by agency research.



With clear changes to the pay strategies happening at the point of IPO, there is the potential for further research in this area. The commanding position of the founders leads to unconditional incentive rewards. However, research shows that founders do depart companies (either willingly or unwillingly). Once this happens, governance strategies again might be changed. There is also the point that the majority of the schemes implemented follow a 3-year cycle from granting to vesting. One cannot ignore the possibility that grants are unconditional, as their implementation has been no more than an experimental view of this type of incentive scheme. Further research based on a longitudinal study of post-IPO dynamics could provide insight into the changes and development of such schemes.

## Conclusions

This article's findings indicate that corporate governance is not an exogenous mechanism that solely provides checks and controls of the efficiency with which companies are run and whether managers make decisions in the interests of shareholders. More specifically, executive incentive schemes are closely related to the distribution of ownership and board power among founding and independent board members; insiders and external block holders. The next step would be to link different governance configurations with organizational outcomes, and previous research has provided evidence of possible effects of the IPO governance characteristics on the level of internationalization (e.g., Carpenter et al., 2003) and performance (Arthurs et al., 2008; Certo et al., 2001; Filatotchev & Bishop, 2002). Although it is beyond the ambitions of this article to specify and test empirically complex linkages among ownership dynamics, incentive schemes, and IPO performance, it helps map out future broad areas and questions for empirical enquiry guided by a processual and behavioral analysis of executive compensation.

## Note

1. We also used a continuous variable related to the retained ownership stake by VCs. This variable produced similar results, but the overall explanatory power of the regression model was lower, so we have not reported these results in this article.

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